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**Article (published version)  
(Refereed)**

**Original citation:**

Faguet, Jean-Paul (2008) Colombia: seizing the peace. [Berkeley review of Latin American studies](#), Fall. pp. 1-6.

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Available in LSE Research Online: March 2010

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Photo by juanpg



## DEVELOPMENT

Candlelight demonstration for peace, Bogotá, February 2008.

# Colombia: Seizing the Peace

by Jean-Paul Faguet

## Introduction

Recent years have brought the Colombian government a string of notable successes against the country's armed insurgencies: the ejection of the left-wing Fuerzas Armadas Revolucionarias Colombianas (FARC) from large swathes of the countryside and the progressive desertion of hundreds of its fighters and leaders; the disarming and disbanding of the rightwing paramilitary Autodefensas Unidas de Colombia (AUC); and the effective neutralization of the Ejército de Liberación Nacional (ELN) as a fighting force. The same period has seen Colombia's economic growth accelerate to sustained levels of between 5 and 8 percent per year, outstripping its Latin American neighbors. Commentators' enthusiasm has grown with the government's remarkable string of successes and luck — the rescue of prominent kidnapee Ingrid Betancourt and the deaths of the FARC's leader and another senior commander. Some even predict Colombia's transformation into a Latin American "tiger,"

with growth and industrialization rising to Chinese levels in the coming years. At a time when Colombia's future looks more prosperous and less violent than its past, it is useful to ask how good things can get for Colombia. Could the lifting of the "war tax" transform its economic prospects? What additional reforms would be needed for Colombia to attain Chinese-style rapid development?

While ending the violence is an historic achievement in its own right, claims that peace will lead naturally to rapid development should be viewed with a skeptical eye. The end of any war will, of course, liberate resources for productive investment and significantly reduce the economic and human costs of violence. International experience shows that ending insurgencies can add modestly to a country's economic growth during the first years of peace. Such gains are not trivial, but they are a long way from Chinese growth rates of 9-10 percent per year, sustained over a generation. Chinese-style growth doubles GDP every nine years; more

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than 400 million Chinese have been lifted out of poverty since market reforms began in 1978. What, in addition to bringing about peace, could a country like Colombia do to accelerate growth into the medium and long term? To answer this question, I review the growing consensus among development theorists about the central role that institutions play in determining development outcomes and then analyze the key institutional reforms that researchers now think drove China's (and India's) transformation from an impoverished agrarian economy to the home of the fastest development in human history. I begin with a quick review of what empirical studies have taught us, and what they have not taught us, about economic growth.

## The Poverty of Cross-Country Studies and the Richness of Institutions

For the past 25 years, the main tool that economists have used to investigate the determinants of growth is cross-country regressions. This involves collecting time-series data for a large number of countries (or, less often, regions) and then searching for factors that correlate with economic growth. Increasingly sophisticated means are used to infer causality from, say, investment levels, literacy rates or trade policy to economic growth.

Some of the principal problems with this approach were pointed out as long ago as 1994, in an article by Robert Solow, widely considered to be the father of growth theory. Solow's critiques were more recently revisited by Kenny (2007, 2001), who found their power undiminished. International cross-country growth regressions, the two authors maintain, have taught us little about economic growth because the techniques they employ suffer from a series of fundamental problems. The first of these is the problem of omitted variables. Even for well studied episodes of growth in a particular country, researchers have at best an incomplete notion of why growth accelerated or decelerated, and disagreements among economists abound. The possibility that a single regression equation can capture all of the relevant factors across a wide variety of countries, over many years, is not high. That would be the case even if some of the more complex historical and cultural variables posited as explanatory factors were well measured, which they are not. Hence it is likely that factors important for explaining growth across many countries are not well-accounted for in these regression results, and thus the insights they provide are poor.

A second problem is the possibility of reverse causality. Researchers use lagged values, instrumental variables and a number of more sophisticated approaches to try to determine the direction of causality between the different

variables in their regressions. But this is difficult to do across heterogeneous countries and long periods of time, especially when some of the most important indicators are, at best, proxies for the variables they seek to measure. Researchers have made some progress in this direction over the past 25 years, but unfortunately we still cannot be certain that, for example, it is investment that increases economic growth and not the other way around. A third problem, as studies by Levine and Reinelt (1992) and Levine and Zervos (1992) point out, is that the results from cross-country regressions are highly sensitive to the choice of explanatory variables. Modest changes in the set of explanatory variables lead to the collapse of key causal relationships posited by the regressions.

Most damning of all is Solow's rejection of the attempt to statistically model the experiences of very different countries — with different histories, institutions and geographies — as if they represented discrete points on a well-defined surface. Cross-country regressions in effect posit a single growth process operating across all countries, where each national experience is a particular manifestation of the process. Such models seem at best improbable, an impression bolstered by the fragility of the results they have produced thus far. Indeed, empirical evidence over the past decade implies the opposite: economic growth is probably not a linear process featuring stable relationships amongst a relatively small number of variables. Rather, growth is highly context-specific, featuring relationships among key variables that change over time and particular causes that produce effects unreliably. Put crudely, different things work in different countries at different times. This is in large part why grand theories of development continually fail.

Recent years have seen a departure from the simple, linear universalism of growth regressions, towards deeper studies of particular country experiences. Rodrik's volume *In Search of Prosperity: Analytical Narratives on Economic Growth* (2003) is a prominent case in point. Such research underlines that the lack of a robust universal theory of growth is not equivalent to a lack of understanding about growth. Quite the opposite.

## The Role of Institutions

The past decade has seen a new wave of research on the institutional determinants of growth (e.g. Acemoglu, Robinson & Johnson 2001; Sokoloff & Engerman 2000), which has provided a great deal of evidence on the importance of "institutions" for a country's long-term development. What exactly are these institutions? Some of the most important features of a country's institutional context include: (i) the degree of civic rights that all citizens





Photo by Barro.

The Shanghai skyline.

enjoy; (ii) the degree of political rights for that all citizens enjoy; (iii) the extent to which all individuals' property rights are guaranteed. Empirical evidence shows that such factors are strongly correlated with economic outcomes and that the effects of institutions persist for centuries. Institutions appear to be potent drivers of economic growth and of development more broadly.

This literature does not endorse a particular form of government or laws. Different institutional forms can produce the constellation of rights and freedoms outlined above. Where they exist, there exists a state of laws and not of men, where individuals are protected from the arbitrary actions of others and are free to develop themselves and their potential.

Such institutions will sound attractive to many readers on a number of grounds. But why should they be associated with economic growth? Because they are inclusive. In both the economy and in politics, institutions based on equality among individuals and the inclusion of all in the national life tend to increase investment and innovation in the long run. Institutions that exclude certain individuals or groups tend to impoverish a country by restricting

the ideas, energies and resources available to a nation's economy and politics. Inclusive institutions contribute to economic growth and to the development of a nation. The implications for development are doubly strong because the institutional characteristics outlined above are a large part of our definition of what development is (see e.g. Sen 1999).

Our discussion thus far operates at a high level of generality. How specifically can a developing country move in the direction of the institutions outlined above? And can such reforms really affect growth? To answer these questions, we consider the recent development successes of India and, especially, China.

## Institutions for Development: A Generation of Rapid Growth in China and India

In a 2008 study, Bosworth and Collins show that China's economic growth has averaged 9.3 percent per year between 1978 and 2004. More surprisingly, they also document that India's rapid growth did not begin after liberalizing reforms in 1991, but rather in 1978, alongside China's (although growth did accelerate after 1993).

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## Economic growth in China and India

Country	Period	Average Yearly Growth
China	1978-2004	9.3%
India	1978-2004 (1993-2004)	5.4% 6.5%

The authors' growth accounting exercise shows that in both cases growth was due mostly to increases in output per worker and not to increases in the number of workers. Worker output, in turn, increased mostly because of improvements in total factor productivity as opposed to increases in the capital stock. This is important because it means that both economies became more efficient over time, and the increasing wealth that each country enjoys is due more to

efficiency gains than to increased inputs. Indeed, India's gains in total factor productivity are quite comparable to those of the East Asian "Tigers" in their heyday (1960-80), while China's gains in total factor productivity are three times as large.

How did India's and, especially, China's workers become so much more productive? Of the various factors that Bosworth and Collins indicate, three stand out:

- Sustained increases in the coverage and quality of education, especially in China;
- Notable improvements in infrastructure;
- In China: Sizable internal migration that transfers underemployed human resources from rural to urban areas, where their productivity tends strongly to increase.

Chinese schoolchildren.



Photo by Steven Yuen-Pak Liu.



All three factors are notable for increasing the inclusiveness of each country's economy and polity. An extensive, good quality public education system is a necessary prerequisite if ordinary citizens are to have full access to economic opportunities, political debate and social and cultural interactions more broadly defined. Infrastructure also serves the cause of inclusiveness by decreasing transport and communication costs and improving people's access to places, goods and ideas. And in China, migration was the means for millions to join the modern economy.

Two well-known social science facts are that economic growth is socially disruptive, and institutional reform is politically disruptive. How, then, did China manage such deep institutional reforms and then the sustained, rapid growth that followed? What tools did they use to get the effects they achieved? Qian (2005) identifies four "transition institutions" that played a key role in China's reform process. The first of these was the dual-track price system, under which fixed quantities of goods were produced and allocated at fixed prices under the old planning system. But at same time, a market track was introduced in which prices and quantities were determined by free market mechanisms for all quantities above the plan. The aggregate effect was that prices were liberalized at the margin, while inframarginal prices and quantities were maintained for some time before being phased out. This was a way to implement reform that cushioned losers. The command economy continued to provide basic items at low prices. Once production quotas were filled, additional production — and consumption — could occur at prices and quantities set by free supply and demand.

China's well-known Township-Village Enterprises (TVEs) formed a second type of transition institution. These created decentralized "private" firms in a command economy context devoid of private property rights, where there was no guarantee of control over assets or cash flow. Placing TVEs under the control of local authorities gave local officials access to expanded future revenue streams from a growing economy. This in turn created strong incentives for local authorities to invest in public goods. Anticipating this, the central government left larger budget residuals for local governments to invest. In this way, reform created a virtuous and self-sustaining circle of devolution, investment and growth.

A third transition institution was fiscal federalism. Before reform of central-provincial relations, central government extracted 80 percent of increases in provincial revenues. After reform, provinces kept the lion's share of increases. This gave provincial governments strong incentives to support TVEs and the market economy and

to stimulate economic development because they benefitted directly from increased revenue flows. A fourth transition institution was anonymous banking which allowed for secret (nameless) bank accounts and transactions that deprived the state of the information needed to expropriate the gains of society's rich, productive members. Anonymous banking was important because it constrained a powerful state with few checks on its authority. It also preserved private incentives to save, invest and produce in a legal context that had no private guarantees of property and hence no guarantees that entrepreneurs would enjoy the fruits of innovation and effort.

These, then, are some of the key instruments used by Chinese reformers to effect deep institutional reform while avoiding social conflict. "These institutions work because they achieve the two objectives at the same time — they improve economic efficiency on the one hand, and make the reform compatible for those in power on the other" (Qian 2005: 305). Their ability to serve both functions makes them superior (for the Chinese case) to other more orthodox, textbook-style solutions that have been tried in many transition and developing countries, where reformers have tried to leap directly to "cutting edge" institutional forms, with much less success.

There are several important lessons that China teaches us. The first is that we should study not the final destination we wish to achieve but rather feasible paths towards it. "Optimal" solutions that are politically unattainable are of little use. Secondly, institutional reform is fiendishly complex, especially where it intersects with economic growth and development. One need go no further than TVEs, which have their roots in the collectivization of agriculture in China, a direct precursor of the great famine of 1959-61. In the 1970s wave of rural industrialization, they proved moderately successful as a means of organizing production. But they became phenomenally successful in the 1980s as an engine of growth, and a driving force for market reform, in the ways described above — one institutional form, one country, three utterly different outcomes.

The problem of institutional reform has no magic solutions, no silver bullets. Complementary changes are often required for particular organizational forms to become beneficial. What these complementary changes are, and how precisely they should be phased in, are problems for which there is usually no obvious solution. Hence trial and error — something at which the Chinese have excelled — are key. Because there is no foolproof way to design a particular institution, reformers are far better off sticking to gradual reform and a practical empiricism.

## Conclusions

What lessons can we draw from these theoretical and empirical analyses for the case of Colombia? The easiest lesson is that while the hoped-for end of violence is likely to be good for growth and development, the magnitude and persistence of such effects cannot be predicted. Nor can the effects of the raft of specific reforms (e.g. of pensions, taxes, financial supervision, fiscal relations) advocated by Colombian analysts, the IMF and others in the name of “seizing the peace.” As we saw above, economic growth is not a linear process, and the effects of specific measures can differ by country and across time.

But the institutional literature gives us significant insight into the determinants of long-term growth. Institutions that support sustained growth and high levels of development are the ones that guarantee civic and political rights, as well as property rights, and do so extensively and inclusively for essentially all of their citizens. Such institutions raise the long-term development performance of a country by harnessing the energies, resources and inspiration of all its citizens to help overcome the nation’s economic and political challenges.

The evidence from China and India implies that Colombia can accelerate its growth and development through sustained investments in education and infrastructure and a sustained and progressive inclusion of Colombia’s

population in the benefits of such investments. No longer should Colombians be satisfied with their “internal frontier,” which divides a modern, prosperous urban nation from a backwards, forgotten rural hinterland. The experience of China argues for extensive human and physical capital investments that serve the dual purpose of increasing the productive base and drawing more citizens into the national economic and political life. Such reforms should be pursued not only because they comprise laudable social goals in and of themselves but because they will also support Colombian growth and development into the long term.

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The road to Bogotá.



Photo by Philip Bouchard.